LEGISLATIVE SERVICES AGENCY
OFFICE OF FISCAL AND MANAGEMENT ANALYSIS

301 State House
(317) 232-9855

FISCAL IMPACT STATEMENT

LS 6559 | **DATE PREPARED:** Dec 28, 2001
BILL NUMBER: HB 1352 | **BILL AMENDED:**

SUBJECT: Income Tax Deductions and Inheritance Tax Repeal.

FISCAL ANALYST: Jim Landers
PHONE NUMBER: 232-9869

FUNDS AFFECTED: X GENERAL
X DEDICATED
FEDERAL

IMPACT: State & Local

Summary of Legislation: *Inheritance and Estate Taxes:* The bill provides that the Indiana Inheritance Tax does not apply to transfers from the estate of an individual who dies after June 30, 2002. The bill provides that the Indiana Estate Tax does not apply to the estate of an individual who dies after December 31, 2004. It also provides that the Indiana Generation Skipping Transfer Tax does not apply to the estate of an individual who dies after December 31, 2009, and before January 1, 2011. The bill also makes conforming amendments and repeals statutes imposing the Inheritance Tax.

Additional AGI Tax Deduction for the Elderly: The bill increases from $500 to $1,000 the additional deduction from Adjusted Gross Income (AGI) for taxpayers and their spouses who qualify for the federal deduction for the aged, subject to certain income limits.

AGI Tax Deduction for Pension and IRA Distributions: The bill provides an Adjusted Gross Income (AGI) Tax deduction for pension and annuity income and IRA distributions, to the extent these amounts are included in Federal Adjusted Gross Income.

AGI Tax Deduction for Federal Civil Service Annuities and Military Retirement: The bill also increases the Adjusted Gross Income (AGI) Tax deduction for recipients of Federal civil service annuities and for military retirement or survivor's benefits.

Inflation Adjustment of Personal and Spousal Exemption: The bill requires certain deductions from an individual's Adjusted Gross Income to be adjusted according to the Consumer Price Index.

Effective Date: January 1, 2002 (retroactive); July 1, 2002; July 1, 2004.

Explanation of State Expenditures: *Inheritance Tax Repeal:* Once the Inheritance Tax is repealed, there could be a savings to the state from a reduction in staff in the Inheritance Tax Section of the Department of State Revenue. The October 2, 2001, state manning table indicates that the Inheritance Tax Section has 15 full-time employees and one part-time employee. The annual salary cost for these employees is $464,334. Since staff members would still be needed to process returns, a specific savings due to staff reductions could not be estimated.

County Inheritance Tax Replacement: In addition to eliminating Inheritance Tax revenue to the state, the bill would eliminate the resident Inheritance Tax revenue retained by the counties. The annual revenue loss to counties is estimated to be approximately $9.9 M statewide beginning in FY 2004. As a result of the revenue loss, the bill would increase expenditures from the state General Fund relating to the Inheritance Tax replacement for counties. The maximum amount of county replacement for any year is approximately $7.5 M. With the repeal of the Inheritance Tax, this amount would continue to be paid to the counties. Since the Inheritance Tax does not have to be paid until a maximum of 12 months after the decedent's death (within 9 months of the date of death to receive the 5% early payment discount), the impact of the bill is not expected to begin until FY 2004. (See *Explanation of Local Revenues*, below, for further explanation of the replacement procedure.)

AGI Tax Changes: The Department of State Revenue (DOR) would incur some administrative expenses relating to the revision of tax forms, instructions, and computer programs to incorporate these changes. These expenses presumably could be absorbed given the DOR's existing budget and resources.

Explanation of State Revenues: *Inheritance and Estate Taxes:* The bill would eliminate the Inheritance Tax beginning with transfers from persons who die after June 30, 2002. This would eliminate revenue from the Inheritance Tax and could potentially lead to an increase in revenue from the Indiana Estate Tax until FY 2007. This offset by the Estate Tax will decline to zero by FY 2007 due to increases in the federal unified credit and the phaseout of the federal state death tax credit. (Note: Consistent with federal changes, the bill effectively eliminates the Indiana Estate Tax beginning with 2005 decedents.) The estimated impact of the bill on Inheritance Tax and Estate Tax revenue and the net loss to the state, including county replacement funding, is presented in the table below. Since the Inheritance Tax does not have to be paid until a maximum of 12 months after the decedent's death (within 9 months of the date of death to receive the 5% early payment discount), the impact of eliminating the tax likely would not be experienced until FY 2004.

Fiscal Year	Inheritance Tax Revenues	Estate Tax Revenues	State Expenditures for County Replacement	Net Increase (Decrease)
2004	($115.2 M)	$26.9 M	($7.5 M)	($95.8 M)
2005	($115.2 M)	$16.7 M	($7.5 M)	($105.9 M)
2006	($115.2 M)	$5.2 M	($7.5 M)	($117.5 M)
2007 and after	($115.2 M)	$0	($7.5 M)	($122.7 M)

The estimated revenue loss is based on the Revenue Technical Committee's updated FY 2003 forecast for the Inheritance Tax (November 14, 2001) equal to $140 M and assumes that revenue in subsequent years will remain the same. The forecast total includes revenue from the Indiana Estate Tax. Based on FY 2001 collections, roughly 17.7% of this total is derived from the Estate Tax. This suggests that Inheritance Tax revenue is forecast at approximately $115.2 M and Estate Tax revenue at about $24.8 M.

The elimination of Inheritance Tax liabilities could potentially have an impact on Indiana Estate Tax revenues. Indiana Estate Tax is owed on the assets of an estate if (1) federal Estate Tax is owed on the estate and (2) the Indiana portion of the federal state death tax credit (against the federal Estate Tax) exceeds the total Inheritance Tax paid by transferees of the estate. Since the Inheritance Tax is eliminated, the Estate Tax liability would be equal to the Indiana portion of the state death tax credit. The bill reflects this change. Consequently, for estates that owe federal Estate Tax, the elimination of the Inheritance Tax liability for transferees of the estate results in a compensating increase in the Estate Tax liability.

The estimated impact of the bill on Estate Tax revenues is based on an OFMA database of Estate Tax returns relating to decedents who died between July 1, 1997, and June 30, 2000. The database consists of 559 estates upon which Indiana Estate Tax was paid. Elimination of the Inheritance Tax liability for the sample increased the Estate Tax liability of the sample by a factor of approximately 4.9 for FY 2004, 7.2 for FY 2005, and 8.1 for FY 2006. Based on the FY 2003 revenue forecast (as of November 14, 2001) and accounting for the impact of the recent federal Estate Tax changes, Indiana Estate Tax revenues are estimated to be about $6.98 M in FY 2004, $2.7 M in FY 2005, and $735,000 in FY 2006. The recent federal law changes accelerate the scheduled increase in the unified credit and begin phasing out the state death tax credit in 2002. These estimates are increased by the factors specified above to derive the impact of the Inheritance Tax changes on the Estate Tax.

Generation Skipping Transfer Tax: The bill prohibits the Indiana Generation Skipping Transfer Tax from applying to estates of decedents who die during 2010. This conforms to the repeal of the federal Generation Skipping Transfer Tax to which the Indiana tax is linked. According to the Department of State Revenue, this tax has accounted for very little revenue during its history. As a result, any impact this provision may have will occur well into the future and likely will be very minimal.

The Indiana Generation Skipping Transfer Tax depends on a credit against the federal Generation Skipping Transfer Tax. The Federal tax and credit are to be repealed in 2010, but could return in 2011 as a result of a sunset provision on the federal legislation that included the repeal. In order to comply with the Congressional Budget Act of 1974, the provisions of this legislation will sunset on December 31, 2010. Congressional observers expect that the provisions of the Act will be extended or made permanent at some point in the future. Reportedly, the House leadership has indicated that legislation to make the provisions of the Act permanent will be considered in the near future.

AGI Tax Deduction for Pension and IRA Distributions: The bill allows a taxpayer to deduct income from pensions, annuities, and taxable IRA distributions from Adjusted Gross Income (AGI). In 2002 and 2003, an individual may deduct the lesser of: (1) pension and annuity income or IRA distributions (for those at least 59 and one-half years old) that were included in the taxpayer's federal AGI; or (2) $5,000. In 2004, the maximum deduction would be increased from $5,000 to $10,000. Since this change would be effective beginning with tax year 2002, the annual fiscal impact would begin in FY 2003. The reduction in state revenue associated with this bill is estimated to be $94.8 M in FY 2003 and $101.4 M in FY 2004. Once the maximum deduction is increased to $10,000, the impact is projected to be $191.0 M in FY 2005. Revenue from the AGI Tax is deposited in the state General Fund.

The estimated impact is based on federal income tax data from 1996 through 1998. The tax data for 1998 indicates that 465,575 Indiana residents reported taxable pension or annuity income, and 84,456 of these individuals also reported taxable IRA distributions. In addition, 78,501 others also reported taxable IRA income in 1998. The estimates for FY 2003 to FY 2005 are based on the number of taxpayers that would have all or part of this income deemed deductible, the historic rates of change in the number of individuals receiving taxable distributions, and the size of these distributions.

AGI Tax Deduction for Federal Civil Service Annuities: The bill increases the maximum deduction for federal civil service annuities to $5,000 in 2002 and 2003 and to $10,000 beginning in 2004. Since this change would be effective beginning tax year 2002, the annual fiscal impact would begin in FY 2003. The revenue loss from the $5,000 increase in the deduction for federal civil service annuities is estimated to be approximately $5.5 M in FY 2003 and FY 2004. Revenue loss from the increase to $10,000 is estimated to be $11.3 M beginning in FY 2005.

The estimates are based on 1999 income tax return data relating to the civil service deduction and data from the federal Office of Personnel Management. Currently, there are 24,914 federal retirees and 8,908 surviving spouses residing in Indiana. These individuals will receive civil service annuity payments totaling approximately $598.4 M during 2001. The average annuity for retirees and survivors in 2001 exceeds $10,000. As a result, the estimates assume that each annuitant is able to claim a maximum deduction of $5,000 or $10,000. It is important to note, however, that the actual revenue loss could potentially be less than the estimates depending upon the extent that annuitants also receive social security benefits.

AGI Tax Deduction for Military Retirement: The bill increases the maximum deduction for military retirement and survivor's benefits to $5,000 in 2002 and 2003 and to $10,000 beginning in 2004. Since this change would be effective beginning tax year 2002, the annual fiscal impact would begin in FY 2003. The increase to $5,000 is estimated to reduce revenue by approximately $2.0 M in FY 2003 and FY 2004. The increase to $10,000 is estimated to reduce revenue by about $5.2 M in FY 2005. Revenue from the AGI Tax is deposited in the state General Fund.

The estimated impact is based on 1999 income tax return data relating to the military service deduction. This data indicates that approximately $67.4 M in military service income was deducted from taxable income in 1999, about $42.7 M of which is estimated to be attributable to military retirees. This is based on the total number of military retirees reported in Indiana in 1999 by the Department of Defense. Retirement pay data for 1996 to 2001 from the Department of Defense also suggests an average exceeding $10,000. Therefore, the estimates assume that all military retirees would be able to claim a maximum $5,000 or $10,000 deduction. The 1999 deduction amount is utilized to estimate deduction amounts given a $5,000 and $10,000 maximum. These 1999 amounts are then estimated for 2002, 2003, and 2004 based on the 2.2% annual decline in the military service deduction that has been observed in recent years.

Additional AGI Tax Deduction for the Elderly: The bill increases from $500 to $1,000 the AGI Tax deduction for taxpayers who are 65 years of age or older and have a federal AGI less than $40,000. Since this change would be effective beginning tax year 2002, the annual fiscal impact would begin in FY 2003. The revenue loss due to this change could potentially total approximately $7.9 M to $9.4 M in FY 2003 and $8.0 M to $9.5 M in FY 2004. Revenue from the AGI Tax is deposited in the state General Fund.

The estimates are based on individual tax return data from 1999 indicating that 451,726 eligible taxpayers claimed the current $500 deduction. The resultant revenue loss is estimated to be approximately $7.7 M. The estimates for FY 2003 and FY 2004 specified above are based on the 1999 totals. The low range estimates assume that the number of taxpayers claiming the deduction will grow by 1% per year. Individual tax return data indicates that the number of taxpayers claiming the exemption for those who are 65 years of age or older or blind has increased annually by an average of 1%. Population estimates by the U.S. Census Bureau tend to confirm this long-run trend. The Census estimates suggest that the number of Indiana residents 65 and older has increased by about 0.84% per year since 1989. Based on annual growth of 1%, the number of taxpayers claiming the additional elderly deduction is estimated to total 465,414 in tax year 2002 and 470,068 in 2003. In contrast, the high range revenue loss estimates assume high rates of growth initially. Since 1999 was the first year that additional elderly deduction was in effect, there may be some lag in taxpayer response leading to higher rates of growth in the initial few years of the deduction. For example, the additional AGI Tax exemption for dependent children initiated in 1997 experienced growth rates in the second and third years of 13.34% and 7.11%, respectively. Assuming that the number of taxpayers claiming the additional elderly deduction increases by similar rates in 2000 and 2001, and then increases by 1% per year thereafter, the number of taxpayers claiming the deduction in 2002 and 2003 is estimated to total 554,166 and 559,707, respectively.

Inflation Adjustment of Personal and Spousal Exemption: The bill requires the existing $1,000 exemptions for taxpayers and their spouses to be adjusted annually for inflation beginning in tax year 2003. The inflation adjustment is to be performed using the Consumer Price Index (CPI) computed by the U.S. Bureau of Labor Statistics. The exemption amounts would be increased each year by the percentage change in the CPI (unless the change is negative, in which case exemptions would remain unchanged for that year). Since this change would be effective beginning tax year 2003, the annual fiscal impact would begin in FY 2004. The revenue loss due to this provision could potentially total approximately $4.4 M in FY 2004. Revenue from the AGI Tax is deposited in the state General Fund.

The estimated impact of this provision is based on recent tax return counts for single, separate, and joint filers, and average annual growth in the CPI. Counts of single, separate, and joint tax returns filed in 1999 indicate that a total of approximately 4,260,231 individuals were claimed under either the taxpayer personal exemption or the spousal exemption. Return counts from 1996 to 1999 indicate average annual growth of 1.94% in the taxpayer and spousal exemption. Based on the 1999 totals and the recent trends in exemptions claimed, the taxpayer and spousal exemption total is projected to equal 4,601,358 in 2003. The $1,000 exemptions are inflated by 2.8% for 2003 based on the average annual rate of growth in the CPI from 1990 to 2000.

Due to the annual growth in the CPI and in the number of people claimed under these exemptions, the revenue loss is expected to increase annually. (For instance, at 2.8% growth in the CPI, the 2004 taxpayer and spousal exemptions would increase from $1,028 to $1,052.) It is also important to note that actual year-to-year growth in the CPI from 1990 to 2000 ranged from a low of 1.55% in 1998 to a high of 5.4% in 1990.

A summary of the provisions of this bill is outlined in the table below.

	FY2003	**FY2004**
State Revenues (millions)		
Inheritance Tax Repeal		(88.3 M)
Pension/IRA Deduction	(94.8 M)	(101.4 M)
Civil Service Annuities Deduction Increase	(5.5 M)	(5.5 M)
Military Retirement Deduction Increase	(2.0 M)	(2.0 M)
Add'l Elderly Deduction Increase	(7.9 M - 9.4 M)	(8.0 M - 9.5 M)
Inflation Adjustment of Personal Exemptions		(4.4 M)
Total State Revenues	**(110.2 M - 111.7 M)**	**(209.6 M - 211.1 M)**
State Expenditures		
County Inheritance Tax Replacement		7.5 M
Net Increase (Decrease)	**(110.2 M - 111.7 M)**	**(217.1 M - 218.6 M)**

Explanation of Local Expenditures:

Explanation of Local Revenues: *Inheritance Tax Repeal:* The repeal of the Inheritance Tax is estimated to result in an annual net revenue loss to counties of $2.5 M statewide beginning in FY 2004. The annual impact beginning in FY 2004 is summarized in the table below.

	Annual Impact Beginning in FY 2004
Inheritance Tax Revenues	($9.9 M)
State Expenditures for County Replacement	$7.5 M
Net Increase (Decrease)	($2.5 M)

Counties retain 8% of the Inheritance Tax collected on transfers made by Indiana residents. The repeal of the Inheritance Tax is estimated to reduce county Inheritance Tax collections by approximately $9.9 M. This is based on the Revenue Technical Committee's updated FY 2003 forecast (as of November 14, 2001) for the Inheritance Tax and assumes that revenue will remain the same in subsequent years. It is important to note that a reduction in the amount of Inheritance Tax retained by counties due to the bill may be reimbursed by the state under the replacement provision established by P.L. 254-1997. The table also specifies the amount of replacement funding the counties will receive beginning in FY 2004. The replacement provision was established when the Class A exemption was increased on July 1, 1997. The replacement provision guarantees that in each fiscal year each county receives an amount under the Inheritance Tax that is equal to the five-year annual average amount of Inheritance Tax revenue retained by that county from FY 1991 to FY 1997, excluding the highest and lowest year. The maximum amount of county replacement for any year is approximately $7.5 M. A copy of a spreadsheet showing the amount of Inheritance Tax replacement guaranteed to each county under P.L. 254-1997 is available from the Office of Fiscal and Management Analysis.

AGI Tax Changes: Because the proposed changes would serve to decrease taxable income, counties imposing local option income taxes (CAGIT, COIT, and/or CEDIT) may, as a result, experience an indeterminable decrease in revenue from these taxes.

State Agencies Affected: Department of State Revenue.

Local Agencies Affected: Counties.

Information Sources: U. S. Census Bureau, *Resident Population for Selected Age Groups: 1980 to 1989*, March 1995; U.S. Census Bureau, *Population 65 Years and Over and 85 Years and Over, Region, and State: 1998*, February 11, 2000; DOR State and Federal Income Tax data for various years; State Revenue Forecast, November 14, 2001; Bill Reynolds, Indiana Department of State Revenue, 232-2075; OFMA Inheritance and Estate Tax Databases; OFMA County Replacement Spreadsheet.